

ARIZONA CORPORATION COMMISSION
UTILITIES DIVISION

ANNUAL REPORT MAILING LABEL – MAKE CHANGES AS NECESSARY

67-04201A
UNS GAS, INC.

Attention: Karen Kissinger-Vice President, Controller & Chief Compliance Officer
P.O. Box 711, Mail Stop OH-120
Tucson, AZ 85702

RECEIVED

APR 15 2004

AZ CORPORATION COMMISSION
DIRECTOR OF UTILITIES

ANNUAL REPORT

FOR YEAR ENDING

12	31	2003
----	----	------

FOR COMMISSION USE

ANN 01	03
--------	----

PROCESSED BY:

SCANNED

COMPANY INFORMATION

Company Name (Business Name) UNS Gas, Inc.

Mailing Address P.O. Box 711, Mail Stop OH-120

(Street)

Tucson

(City)

Arizona

(State)

85702

(Zip)

520-571-4000

Telephone No. (Include Area Code)

520-571-4160

Fax No. (Include Area Code)

N/A

Pager/Cell No. (Include Area Code)

Email Address jlebrecht@tep.com or kkissinger@tep.com

Local Office Mailing Address P.O. Box 711, Mail Stop OH-120

(Street)

Tucson

(City)

Arizona

(State)

85702

(Zip)

520-571-4000

Local Office Telephone No. (Include Area Code)

520-571-4160

Fax No. (Include Area Code)

N/A

Pager/Cell No. (Include Area Code)

Email Address jlebrecht@tep.com or kkissinger@tep.com

MANAGEMENT INFORMATION

Management Contact: David Couture

(Name)

Director of Regulatory Services

(Title)

3950 East Irvington Road, Mail Stop OH-122

(Street)

Tucson

(City)

Arizona

(State)

85714

(Zip)

520-745-3422

Telephone No. (Include Area Code)

520-571-4106

Fax No. (Include Area Code)

520-410-1795

Pager/Cell No. (Include Area Code)

Email Address dcouture@tep.com

On Site Manager: Gary Smith

(Name)

Vice President and General Manager

2901 W. Shamrell Blvd., Suite 110

(Street)

Flagstaff

(City)

Arizona

(State)

86001

(Zip)

928-226-2233

Telephone No. (Include Area Code)

928-226-2203

Fax No. (Include Area Code)

N/A

Pager/Cell No. (Include Area Code)

Email Address gasmith@uesaz.com

☒ Please mark this box if the above address(es) have changed or are updated since the last filing.

UNS Gas acquired assets from Citizens Communications on August 11, 2003. This report reflects changes in addresses from the reports previously filed by Citizens Communications.

Statutory Agent: Diana K. Durako

(Name)

One South Church Avenue, Suite 1820

(Street)

Tucson

(City)

Arizona

(State)

85701

(Zip)

520-571-4000 ext. 3652

Telephone No. (Include Area Code)

520-571-3612

Fax No. (Include Area Code)

N/A

Pager/Cell No. (Include Area Code)

Attorney: Vincent Nitido, Jr.

(Name)

P.O. Box 711

(Street)

Tucson

(City)

Arizona

(State)

85702

(Zip)

520-571-4000 ext. 3670

Telephone No. (Include Area Code)

520-571-3612

Fax No. (Include Area Code)

N/A

Pager/Cell No. (Include Area Code)

☒ Please mark this box if the above address(es) have changed or are updated since the last filing.

OWNERSHIP INFORMATION

Check the following box that applies to your company:

☐ Sole Proprietor (S)

☒ C Corporation (C) (Other than Association/Co-op)

☐ Partnership (P)

☐ Subchapter S Corporation (Z)

☐ Bankruptcy (B)

☐ Association/Co-op (A)

☐ Receivership (R)

☐ Limited Liability Company

☐ Other (Describe) _____

COUNTIES SERVED

Check the box below for the county/ies in which you are certificated to provide service:

☒ APACHE

☐ COCHISE

☒ COCONINO

☐ GILA

☐ GRAHAM

☐ GREENLEE

☐ LA PAZ

☐ MARICOPA

☒ MOHAVE

☒ NAVAJO

☐ PIMA

☐ PINAL

☒ SANTA CRUZ

☒ YAVAPAI

☐ YUMA

☐ STATEWIDE

SERVICES AUTHORIZED TO PROVIDE

Check the following box/es for the services that you are authorized to provide:

☐ **Electric**

- ☐ Investor Owned Electric
- ☐ Rural Electric Cooperative
- ☐ Utility Distribution Company
- ☐ Electric Service Provider
 - ☐ Transmission Service Provider
 - ☐ Meter Service Provider
 - ☐ Meter Reading Service Provider
 - ☐ Billing and Collection
 - ☐ Ancillary Services
 - ☐ Generation Provider
 - ☐ Aggregator/Broker

☐ **Telecommunications**

- ☐ Incumbent Local Exchange Carrier
- ☐ Interexchange Carrier
- ☐ Competitive Local Exchange Carrier
- ☐ Reseller
- ☐ Alternative Operator Service Provider

☒ **Gas**

- ☒ Natural Gas
- ☐ Propane

☐ **Other** (Specify) _____

STATISTICAL INFORMATION

TELECOMMUNICATION UTILITIES ONLY

Total residential access lines	_____
Total business access lines	_____
Total revenue from Arizona operations	\$ _____
Total income from Arizona operations	\$ _____
Value of assets used to serve Arizona customers	\$ _____
Accumulated depreciation associated with those assets	\$ _____

STATISTICAL INFORMATION (CONT'D)

ELECTRIC UTILITY PROVIDERS ONLY

Total number of customers	
Residential	
Commercial	
Industrial	
Public street and highway lighting	
Irrigation	
Resale	
Total kilowatt-hours sold	
Residential	
Commercial	
Industrial	
Public street and highway lighting	
Irrigation	
Resale	
Maximum Peak Load	

kWh

MW

GAS UTILITIES ONLY (4)

Total number of customers (at 12-31-03)	127,600
Residential	116,055
Commercial	10,497
Industrial	19
Irrigation	8
Public Authority	998
Transportation Service with Negotiated Sales Program Contract (1)	17
Transportation Service without Negotiated Sales Program Contract (2)	4
Electric Generation (3)	2
Total therms sold	92,653,990
Residential	25,165,503
Commercial	12,231,054
Industrial	1,151,286
Irrigation	45,043
Public Authority	2,460,737
Transportation Service with Negotiated Sales Program Contract (1)	7,508,915
Transportation Service without Negotiated Sales Program Contract (2)	557,042
Electric Generation (3)	43,534,410

therms

- (1) Under the Company's Negotiated Sales Program tariff, it may compete for the gas commodity business of its transportation customers. This line includes those transportation customers for which we also provide their gas commodity.
- (2) Transportation Service customers are billed a usage rate that does not include the cost of gas. Quantity indicated represents customer procured gas delivered through UNS Gas, Inc. facilities.
- (3) UNS Gas transports gas to two electrical generating facilities. For a portion of 2003, UNS Gas also provided some of the gas commodity required by one of these customers. The quantity indicated represents the total volume of gas delivered to these customers over UNS Gas facilities irrespective of whether such gas was procured by the customer or UNS Gas.
- (4) Statistics on this schedule reflect activity from the date of acquisition of assets from Citizens Communications (August 11, 2003) through December 31, 2003.

**VERIFICATION
AND
SWORN STATEMENT
Intrastate Revenues Only**

RECEIVED

VERIFICATION

STATE OF Arizona

I, THE UNDERSIGNED

OF THE

COUNTY OF (COUNTY NAME) Pima	APR 15 2004
NAME (OWNER OR OFFICIAL) TITLE Karen G. Kissinger, VP, Controller & CCO	
COMPANY NAME UNS Gas, Inc.	

**AZ CORPORATION COMMISSION
DIRECTOR OF UTILITIES**

DO SAY THAT THIS ANNUAL UTILITY REPORT TO THE ARIZONA CORPORATION COMMISSION

FOR THE YEAR ENDING

MONTH 12	DAY 31	YEAR 2003
-------------	-----------	--------------

HAS BEEN PREPARED UNDER MY DIRECTION, FROM THE ORIGINAL BOOKS, PAPERS AND RECORDS OF SAID UTILITY; THAT I HAVE CAREFULLY EXAMINED THE SAME, AND DECLARE THE SAME TO BE A COMPLETE AND CORRECT STATEMENT OF BUSINESS AND AFFAIRS OF SAID UTILITY FOR THE PERIOD COVERED BY THIS REPORT IN RESPECT TO EACH AND EVERY MATTER AND THING SET FORTH, TO THE BEST OF MY KNOWLEDGE, INFORMATION AND BELIEF.

SWORN STATEMENT

IN ACCORDANCE WITH THE REQUIREMENT OF TITLE 40, ARTICLE 8, SECTION 40-401, ARIZONA REVISED STATUTES, IT IS HEREIN REPORTED THAT THE GROSS OPERATING REVENUE OF SAID UTILITY DERIVED FROM ARIZONA INTRASTATE UTILITY OPERATIONS DURING CALENDAR YEAR 2003 WAS:

Arizona Intrastate Gross Operating Revenues Only (\$)


\$ 51,346,074

(THE AMOUNT IN BOX ABOVE
INCLUDES \$ 4,048,665 IN SALES AND FRANCHISE
TAXES BILLED, OR COLLECTED)

****REVENUE REPORTED ON THIS PAGE MUST INCLUDE SALES TAXES BILLED OR COLLECTED. IF FOR ANY OTHER REASON, THE REVENUE REPORTED ABOVE DOES NOT AGREE WITH TOTAL OPERATING REVENUES ELSEWHERE REPORTED, ATTACH THOSE STATEMENTS THAT RECONCILE THE DIFFERENCE. (EXPLAIN IN DETAIL)**

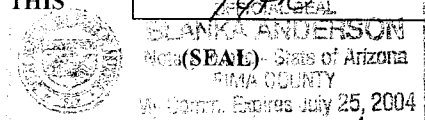
SUBSCRIBED AND SWORN TO BEFORE ME

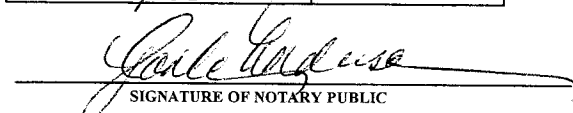
A NOTARY PUBLIC IN AND FOR THE COUNTY OF


SIGNATURE OF OWNER OR OFFICIAL
745-3122
TELEPHONE NUMBER

THIS 14th DAY OF

COUNTY NAME <u>Pima</u>	
MONTH <u>April</u>	YEAR <u>2004</u>




SIGNATURE OF NOTARY PUBLIC

MY COMMISSION EXPIRES July 25, 2004

VERIFICATION
AND
SWORN STATEMENT
RESIDENTIAL REVENUE
INTRASTATE REVENUES ONLY

RECEIVED

APR 15 2004

AZ CORPORATION COMMISSION

STATE OF ARIZONA

I, THE UNDERSIGNED

OF THE

COUNTY OF (COUNTY NAME) Pima		DIRECTOR OF UTILITIES
NAME (OWNER OR OFFICIAL) Karen G. Kissinger	TITLE VP, Controller & CCO	
COMPANY NAME UNS Gas, Inc.		

DO SAY THAT THIS ANNUAL UTILITY REPORT TO THE ARIZONA CORPORATION COMMISSION

FOR THE YEAR ENDING

MONTH 12	DAY 31	YEAR 2003
--------------------	------------------	---------------------

HAS BEEN PREPARED UNDER MY DIRECTION, FROM THE ORIGINAL BOOKS, PAPERS AND RECORDS OF SAID UTILITY; THAT I HAVE CAREFULLY EXAMINED THE SAME, AND DECLARE THE SAME TO BE A COMPLETE AND CORRECT STATEMENT OF BUSINESS AND AFFAIRS OF SAID UTILITY FOR THE PERIOD COVERED BY THIS REPORT IN RESPECT TO EACH AND EVERY MATTER AND THING SET FORTH, TO THE BEST OF MY KNOWLEDGE, INFORMATION AND BELIEF.

SWORN STATEMENT

IN ACCORDANCE WITH THE REQUIREMENTS OF TITLE 40, ARTICLE 8, SECTION 40-401.01, ARIZONA REVISED STATUTES, IT IS HEREIN REPORTED THAT THE GROSS OPERATING REVENUE OF SAID UTILITY DERIVED FROM ARIZONA INTRASTATE UTILITY OPERATIONS RECEIVED FROM RESIDENTIAL CUSTOMERS DURING CALENDAR YEAR 2003 WAS:

ARIZONA INTRASTATE GROSS OPERATING REVENUES

\$ 27,792,936

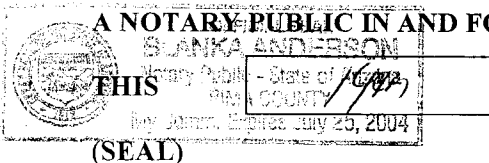
(THE AMOUNT IN BOX AT LEFT
INCLUDES \$ 2,304,183 IN SALES AND
FRANCHISE TAXES BILLED, OR COLLECTED)

*RESIDENTIAL REVENUE REPORTED ON THIS PAGE
MUST INCLUDE SALES TAXES BILLED.

X *Karen G. Kissinger*
SIGNATURE OF OWNER OR OFFICIAL
745-3122
TELEPHONE NUMBER

SUBSCRIBED AND SWORN TO BEFORE ME

A NOTARY PUBLIC IN AND FOR THE COUNTY OF



DAY OF

NOTARY PUBLIC NAME <i>Blanka Anderson</i>	
COUNTY NAME <i>Pima</i>	
MONTH <i>April</i>	20 <i>04</i>

X *Blanka Anderson*
SIGNATURE OF NOTARY PUBLIC

MY COMMISSION EXPIRES

Report of Independent Auditors

To the Board of Directors and Shareholder of
UNS Gas, Inc.

In our opinion, the accompanying balance sheet and statement of capitalization and the related statements of income, stockholder's equity and cash flows present fairly, in all material respects, the financial position of UNS Gas, Inc. (the "Company") at December 31, 2003, and the results of its operations and its cash flows for the period April 14, 2003 (date of inception) to December 31, 2003 in conformity with accounting principles generally accepted in the United States of America. These financial statements are the responsibility of the Company's management; our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit of these statements in accordance with auditing standards generally accepted in the United States of America, which require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.


April 13, 2004

UNS GAS, INC.
STATEMENT OF INCOME
FOR THE PERIOD APRIL 14, 2003 (DATE OF INCEPTION) TO DECEMBER 31, 2003*

- Thousands of Dollars -

Operating Revenues	
Gas Revenue	\$ 46,520
Other Revenues	777
Total Operating Revenues	47,297
Operating Expenses	
Purchased Energy	30,615
Other Operations and Maintenance	8,382
Depreciation and Amortization	2,068
Taxes Other Than Income Taxes	2,112
Total Operating Expenses	43,177
Operating Income	4,120
Other Income (Deductions)	
Interest Income	157
Other Expense	(24)
Total Other Income (Deductions)	133
Interest Expense	
Long-Term Debt	2,455
Other Interest Expense, Net of Amounts Capitalized	(6)
Total Interest Expense	2,449
Income Before Income Taxes	1,804
Income Taxes	727
Net Income	\$ 1,077

*Includes results of operations from the date of acquisition, August 11, 2003

See Notes to Financial Statements.

UNS GAS, INC.
STATEMENT OF CASH FLOWS
FOR THE PERIOD APRIL 14, 2003 (DATE OF INCEPTION) TO DECEMBER 31, 2003*

- Thousands of Dollars -

Cash Flows from Operating Activities	
Cash Receipts from Gas Sales	\$ 38,171
Interest Received	73
Purchased Energy Costs Paid	(24,750)
Wages Paid, Net of Amounts Capitalized	(2,205)
Payment of Other Operations and Maintenance Costs	(4,409)
Taxes Paid, Net of Amounts Capitalized	(1,633)
Net Cash Flows - Operating Activities	5,247
Cash Flows from Investing Activities	
Capital Expenditures	(8,595)
Purchase of Citizens Assets	(137,294)
Other	(2)
Net Cash Flows - Investing Activities	(145,891)
Cash Flows from Financing Activities	
Proceeds from Issuance of Long-Term Debt	100,000
Unamortized Debt Expense	(1,299)
Equity Investment from UniSource Energy Services	50,656
Other	(773)
Net Cash Flows - Financing Activities	148,584
Net Increase in Cash and Cash Equivalents	7,940
Cash and Cash Equivalents, Beginning of Period	-
Cash and Cash Equivalents, End of Year	\$ 7,940

*Includes results of operations from the date of acquisition, August 11, 2003.

See Notes to Financial Statements.

UNS GAS, INC.
BALANCE SHEET

December 31,
2003

ASSETS		- Thousands of Dollars -
Utility Plant		
Plant in Service		\$ 135,932
Construction Work in Progress		9,917
Total Utility Plant		145,849
Less Accumulated Depreciation and Amortization		(1,871)
Total Utility Plant - Net		143,978
Current Assets		
Cash and Cash Equivalents		7,940
Trade Accounts Receivable, Less Allowance for Uncollectible Accounts of \$27		7,473
Unbilled Accounts Receivable		14,601
Receivable from Affiliates		3,821
Materials and Supplies		829
Deferred Income Taxes - Current		212
Under Recovered Purchased Gas Costs		3,160
Other		1,106
Total Current Assets		39,142
Regulatory and Other Assets		
Other Regulatory Assets		354
Other Assets		1,606
Total Regulatory and Other Assets		1,960
Total Assets		\$ 185,080
CAPITALIZATION AND OTHER LIABILITIES		
Capitalization		
Common Stock Equity		\$ 53,085
Long-Term Debt		100,000
Total Capitalization		153,085
Current Liabilities		
Accounts Payable		11,372
Payable to Affiliates		740
Interest Accrued		2,513
Taxes Accrued		5,028
Income Taxes Payable		3,199
Accrued Employee Expenses		369
Other		2,908
Total Current Liabilities		26,129
Deferred Credits and Other Liabilities		
Deferred Income Taxes - Noncurrent		1,226
Other		4,640
Total Deferred Credits and Other Liabilities		5,866
Commitments and Contingencies (Note 6)		
Total Capitalization and Other Liabilities		\$ 185,080

See Notes to Financial Statements.

UNS GAS, INC.
STATEMENT OF CAPITALIZATION

December 31,
2003

COMMON STOCK EQUITY		- Thousands of Dollars -
Common Stock--No Par Value		\$ 52,008
	2003	
Shares Authorized	1,000	
Shares Outstanding	1,000	
Accumulated Earnings		1,077
Total Common Stock Equity		53,085
LONG-TERM DEBT		
Issue	Maturity	
Notes Payable		
Note A	8/11/2011	50,000
Note B	8/11/2015	50,000
Total Stated Principal Amount		100,000
Less Current Maturities		-
Total Long-Term Debt		100,000
Total Capitalization		\$ 153,085

See Notes to Financial Statements.

UNS GAS, INC.
STATEMENT OF CHANGES IN STOCKHOLDER'S EQUITY

	Common Shares Outstanding	Common Stock	Accumulated Earnings	Total Stockholders' Equity
- Thousands of Dollars -				
Balances at April 14, 2003 (Date of Inception)*	-	\$ -	\$ -	\$ -
1,000 Shares of Common stock Issued	1,000	50,656	-	50,656
Noncash Equity Transactions	-	1,352	-	1,352
Comprehensive Income:				
2003 Net Income	-	-	1,077	1,077
Total Comprehensive Income				1,077
Balances at December 31, 2003	1,000	\$ 52,008	\$ 1,077	\$ 53,085

*Includes results of operations from the date of acquisition, August 11, 2003.

UNS GAS, INC.
NOTES TO FINANCIAL STATEMENTS

NOTE 1. NATURE OF OPERATIONS

UNS Gas, Inc. (UNS Gas) procures and transports natural gas to 128,000 customers in Northern Arizona and Santa Cruz county of Arizona. UniSource Energy Services, Inc. (UES), an intermediate holding company, established UNS Gas on April 14, 2003, and owns all of the common stock of UNS Gas and UNS Electric. UniSource Energy Corporation (UniSource Energy) owns all of the common stock of UES.

On August 11, 2003, UNS Gas and UNS Electric, Inc. (UNS Electric) completed the purchase of the Arizona gas and electric system assets from Citizens Communications Company (Citizens). The operating results of UNS Gas and UNS Electric have been included in UES' consolidated financial statements since the acquisition date.

The purchase price and the allocation of the assets acquired and the liabilities assumed based on their estimated fair market values as of the acquisition date are as follows for the gas system assets:

Purchase Price:	-Thousands of Dollars-
Cash Paid	\$135,792
Transaction Costs	2,923
Total Purchase Price	\$138,715

Allocation of Purchase Price:	-Thousands of Dollars-
Property, Plant & Equipment	\$137,187
Current Assets	15,127
Regulatory Assets	384
Long-Term Debt	(487)
Current Liabilities	(10,758)
Deferred Credits and Other Liabilities	(2,738)
Total Purchase Price	\$138,715

UniSource Energy paid \$1.4 million of transaction costs included above that were pushed down to UNS Gas, but are not reported on UNS Gas' Statement of Cash Flows.

References to "we" and "our" are to UNS Gas.

NOTE 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

BASIS OF PRESENTATION

Our accounting policies conform to accounting principles generally accepted in the United States of America (GAAP), including the accounting principles for rate-regulated enterprises.

ACCOUNTING FOR RATE REGULATION

UNS Gas is regulated by the Arizona Corporation Commission (ACC) with respect to retail gas rates, the issuance of securities, and transactions with affiliated parties.

UNS Gas generally uses the same accounting policies and practices used by unregulated companies for financial reporting under GAAP. However, sometimes these principles, such as the Financial Accounting Standards Board's (FASB) Statement of Financial Accounting Standards No. 71, *Accounting for the Effects of Certain Types of Regulation* (FAS 71), require special accounting treatment for regulated companies to show the effect of regulation. For example, in setting UNS Gas' retail rates,

UNS GAS, INC.
NOTES TO FINANCIAL STATEMENTS (CONTINUED)

the ACC may not allow UNS Gas to currently charge their customers to recover certain expenses, but instead may require that these expenses be charged to customers in the future. In this situation, FAS 71 requires that UNS Gas defer these items and show them as regulatory assets on the balance sheet until we are allowed to charge our customers. UNS Gas then amortizes these items as expense to the income statement as those charges are recovered from customers. Similarly, certain revenue items may be deferred as regulatory liabilities, which are also eventually amortized to the income statement as rates to customers are reduced.

The conditions a regulated company must satisfy to apply the accounting policies and practices of FAS 71 include:

- an independent regulator sets rates;
- the regulator sets the rates to recover specific costs of delivering service; and
- the service territory lacks competitive pressures to reduce rates below the rates set by the regulator.

FAS 71 may, at some future date, be discontinued due to changes in the regulatory and competitive environments. If UNS Gas stopped applying FAS 71 to its regulated operations, it would write off the related balances of its regulatory assets as an expense and would write off its regulatory liabilities as income on its income statement. UNS Gas' cash flows would not be affected if it stopped applying FAS 71 unless a regulatory order limited its ability to recover the cost of that regulatory asset. We believe our gas operations continue to meet the criteria for FAS 71.

UTILITY PLANT

UNS Gas reports utility plant at cost. Utility plant includes material and labor costs, contractor costs, construction overhead costs, and an allowance for funds used during construction (AFUDC). We charge maintenance and repairs to operating expense as incurred.

AFUDC represents the estimated cost of debt and equity funds that finance utility plant construction. AFUDC is also allowed on certain in service gas division assets prior to their inclusion in rate base. We recover AFUDC in rates through depreciation expense over the useful life of the related asset. For the period August 11, 2003 through December 31, 2003, UNS Gas imputed the cost of capital on construction expenditures at an average of 7.85%. The component of AFUDC attributable to borrowed funds is included as a reduction of Other Interest Expense on the income statement and totaled \$60,000 in 2003. The equity component is included in Interest Income and totaled \$53,000 in 2003.

We compute depreciation of utility plant on a straight-line basis over the service lives of the assets. The average annual depreciation rates for UNS Gas' utility plant for the period of August 11, 2003 through December 31, 2003 was 2.84% for UNS Gas.

CASH AND CASH EQUIVALENTS

Cash and cash equivalents include cash on hand and highly liquid investments with original maturities of three months or less.

MATERIALS AND SUPPLIES

UNS Gas carries transmission and distribution materials and supplies in inventory at the lower of cost or market.

UNS GAS, INC.
NOTES TO FINANCIAL STATEMENTS (CONTINUED)

COMPUTER SOFTWARE COSTS

UNS Gas capitalizes all costs incurred to purchase computer software and amortizes those costs over the estimated economic life of the product. We would immediately expense capitalized computer software costs if the software were determined to be no longer useful.

DEBT

We defer costs related to the issuance of debt. These costs include underwriters' commissions, discounts or premiums, and other costs such as legal, accounting and regulatory fees and printing costs. We amortize these costs over the life of the debt using the straight-line method, which approximates the effective interest method. At December 31, 2003, unamortized debt issuance costs totaled \$1.3 million.

UTILITY OPERATING REVENUES

UNS Gas records revenues from customers when the gas is delivered to our customers. Gas utility revenues are based on rates authorized by the ACC and include revenues applicable to gas consumed from meter reading dates to month end but not yet billed to the customers (unbilled revenue). Unbilled revenues are dependent upon a number of factors, including customer use and weather. Unbilled revenues are reversed the following month when actual billings occur. UNS Gas' Unbilled Accounts Receivable at December 31, 2003 totaled \$15 million. We record an allowance for our estimate of revenues billed for which collection is doubtful. UNS Gas' Allowance for Uncollectible Accounts was \$0.3 million at December 31, 2003.

Other Revenues primarily consist of miscellaneous fees, including service connect and late fees, and revenue from transportation of gas purchased from other providers.

PURCHASED ENERGY COSTS

UNS Gas defers differences between actual gas purchase costs and the recovery of such costs in revenues under a Purchase Gas Adjustor (PGA) mechanism. The PGA mechanism addresses the volatility of natural gas prices and allows UNS Gas to recover its costs through a price adjustor. The PGA charge may be changed monthly based on an ACC approved mechanism that compares the twelve-month rolling average gas cost to the base cost of gas, subject to limitations on how much the price per therm may change in a twelve month period. UNS Gas defers and recovers through the PGA mechanism the difference between the actual cost of UNS Gas' gas supply and transportation contracts and that currently allowed by the ACC. When under or over recovery trigger points are met, UNS Gas may request a PGA surcharge or surcredit with the goal of collecting or returning the amount deferred from or to customers over a twelve month period.

AFFILIATED COMPANY TRANSACTIONS

UNS Gas receives certain corporate and administrative support services from affiliates. These costs, which totaled \$1.5 million from Tucson Electric Power Company (TEP) and \$0.2 million from UNS Electric in 2003, consist primarily of employee compensation and benefits. TEP, a regulated public utility serving retail electric customers in Southern Arizona, is UniSource Energy's largest operating subsidiary.

INCOME TAXES

GAAP requires us to report some of our assets and liabilities differently in our financial statements than we do for income tax purposes. We report the tax effects of differences in these items as deferred

UNS GAS, INC.
NOTES TO FINANCIAL STATEMENTS (CONTINUED)

income tax assets or liabilities in our balance sheet. We measure these tax assets and liabilities using current income tax rates.

DERIVATIVE INSTRUMENTS AND HEDGING ACTIVITIES

UNS Gas applies Statement of Financial Accounting Standards No. 133, *Accounting for Derivative Instruments and Hedging Activities* (FAS 133), as amended. Under FAS 133, all derivative instruments, except those meeting specific exceptions, are recognized in the balance sheet at their fair value. Changes in fair value are recognized immediately in earnings unless specific hedge accounting criteria are met. For derivatives that qualify for hedge accounting, depending on the nature of the hedge, changes in fair value are either offset by changes in the fair value of the hedged assets, liabilities, or firm commitments through earnings, or recognized in other comprehensive income until the hedged item is recognized in earnings.

Management has determined that UNS Gas' physical gas purchases qualify for the normal purchases and normal sales exception provided by FAS 133. This exception applies to physical sales and purchases of gas supply where it is probable that physical delivery will occur, the pricing provisions are clearly and closely related to the contracted prices and the FAS 133 documentation requirements are met.

FAIR VALUE OF FINANCIAL INSTRUMENTS

The carrying amounts of our current assets and liabilities approximate fair value because of the short maturity of these instruments.

UNS Gas considers the principal amounts of the \$100 million of senior unsecured notes issued in August 2003 to be reasonable estimates of their fair value.

USE OF ACCOUNTING ESTIMATES

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

NOTE 3. REGULATORY MATTERS

Concurrent with the closing of the acquisition, retail rate increases for customers of UNS Gas went into effect on August 11, 2003. These rate increases were approved by the ACC on July 3, 2003, when it approved the acquisition and the terms of the April 1, 2003 settlement agreement (UES Settlement Agreement) among UniSource Energy, Citizens, and the ACC Staff.

UNS Gas' retail gas rates include a monthly customer charge, a base rate charge for delivery services and the cost of gas (expressed in cents per therm), and a PGA mechanism.

The related ACC order and the UES Settlement Agreement include the following terms related to UNS Gas rates:

- An increase in retail delivery base rates, effective August 11, 2003, equivalent to a 20.9% overall increase over 2001 test year retail revenues.

UNS GAS, INC.
NOTES TO FINANCIAL STATEMENTS (CONTINUED)

- Fair value rate base of \$142 million and allowed rate of return of 7.49%, based on a cost of capital of 9.05%, derived from a cost of equity of 11.00% and a cost of debt of 7.75% (based on a capital structure of 60% debt and 40% equity).
- The existing PGA rate may not change more than \$0.15 per therm through July 2004. Thereafter, the PGA rate may not change more than \$0.10 per therm.

Under the terms of the ACC order, UNS Gas may not file a general rate increase until August 2006 and any resulting rate increase shall not become effective prior to August 1, 2007.

The UES Settlement Agreement also limits dividends payable by UNS Gas to UniSource Energy to 75% of earnings until the ratio of common equity to total capitalization reaches 40%. UNS Gas' ratio of common equity to total capitalization totals 35% at December 31, 2003.

On March 23, 2004, the ACC approved the termination of the currently effective PGA surcharge of \$0.1155 per therm effective October 31, 2004. The PGA charge remains in effect, and UNS Gas continues to expect full recovery of the PGA bank balance.

Regulatory Assets and Liabilities

At December 31, 2003, regulatory assets and liabilities consist of the following:

Regulatory Assets and Liabilities	
-Thousands of Dollars-	
Regulatory Assets:	
Deferred Year 2000 Costs	\$ 354
Under Recovered Purchased Gas Costs	3,160
Regulatory Liabilities:	
Net Cost of Removal for Interim Retirements	415
Regulatory Assets, Net of Regulatory Liabilities	\$ 3,099

Future Implications of Discontinuing Application of FAS 71

Based on the regulatory asset and liability balances at December 31, 2003, if UNS Gas had stopped applying FAS 71 to its regulated operations, it would have recorded an extraordinary after-tax loss of \$2 million. UNS Gas' cash flows would not be affected if it stopped applying FAS 71 unless a regulatory order limited its ability to recover the cost of its regulatory assets.

UNS GAS, INC.
NOTES TO FINANCIAL STATEMENTS (CONTINUED)

NOTE 4. UTILITY PLANT

The following table shows Utility Plant in Service and depreciable lives by major class at December 31, 2003:

	Plant in Service	Depreciable Lives
	-Thousands of Dollars-	
Gas Distribution Plant	\$ 119,655	17 – 48 years
Gas Transmission Plant	9,128	37 – 55 years
General Plant	6,829	3 – 31 years
Intangible Plant	320	5 – 25 years
Total Plant in Service	\$ 135,932	

Intangible Plant primarily represents computer software costs.

NOTE 5. LONG-TERM DEBT

On August 11, 2003, UNS Gas issued a total of \$100 million of aggregate principal amount of senior unsecured notes in a private placement. Proceeds from the note issuance were paid to Citizens to purchase the Arizona gas system assets. UNS Gas issued \$50 million of 6.23% Notes due August 11, 2011 and \$50 million of 6.23% Notes due August 11, 2015. Both series of notes may be prepaid with a make-whole call premium reflecting a discount rate equal to an equivalent maturity U.S. Treasury security yield plus 50 basis points. UNS Gas incurred a total of \$1.3 million in debt costs related to the issuance of the notes. These costs were deferred and are being amortized over the life of the notes. UES guaranteed the notes.

The note purchase agreements contain certain restrictive covenants, including restrictions on transactions with affiliates, mergers, liens to secure indebtedness, restricted payments, incurrence of indebtedness, and minimum net worth. The actual and required minimum net worth levels at December 31, 2003 follow:

	Required Minimum Net Worth	Actual Net Worth
	-Millions of Dollars-	
UES	\$ 50	\$ 90
UNS Gas	43	53

The incurrence of indebtedness covenant requires UNS Gas to meet certain tests before an additional dollar of indebtedness may be incurred. These tests include (a) a ratio of Consolidated Long-Term Debt to Consolidated Total Capitalization of no greater than 0.67 to 1.00 prior to September 30, 2004, and no greater than 0.65 to 1.00 after September 30, 2004, and (b) an Interest Coverage Ratio (a measure of cash flow to cover interest expense) of at least 2.50 to 1.00. However, UNS Gas may, without meeting these tests, refinance indebtedness and incur short-term debt in an amount not to exceed \$7 million. UNS Gas may not declare or make distributions or dividends (restricted payments) on its common stock unless (a) immediately after giving effect to such action no default or event of default would exist under such company's note purchase agreement and (b) immediately after giving effect to such action, such company would be permitted to incur an additional dollar of indebtedness under the debt incurrence test for such company. As of December 31, 2003, UNS Gas was in compliance with the terms of the note purchase agreement.

UNS GAS, INC.
NOTES TO FINANCIAL STATEMENTS (CONTINUED)

NOTE 6. COMMITMENTS AND CONTINGENCIES

We record liabilities for loss contingencies, including environmental remediation costs, arising from claims, assessments, litigation, fines and penalties and other sources when it is probable that a liability has been incurred and the amount of the assessment can be reasonably estimated.

TRANSPORTATION COMMITMENTS

UNS Gas has firm transportation agreements with El Paso Natural Gas (EPNG) and Transwestern Pipeline Company (Transwestern) with combined capacity sufficient to meet its load requirements. The EPNG and Transwestern contracts expire in August 2011 and January 2007, respectively. EPNG provides gas transportation service under a converted full requirements contract in which UNS Gas pays a fixed reservation charge. In July 2003, FERC required the conversion of UNS Gas' full requirements status under the EPNG agreement to contract demand starting on September 1, 2003. Upon conversion to contract demand status, UNS Gas now has specific volume limits in each month and specific receipt point rights from the available supply basins (San Juan and Permian). These changes will reduce the amount of less expensive San Juan gas available to UNS Gas. However, UNS Gas does not expect the impact to be material. The annual cost of the EPNG capacity after conversion to contract demand was not affected.

UNS Gas made payments under these contracts of \$2 million in 2003. At December 31, 2003, UNS Gas estimates its future minimum payments under these contracts to be:

Purchase Obligations	
-Millions of Dollars-	
2004	\$ 7
2005	7
2006	7
2007	4
2008	4
Total 2004 - 2008	29
Thereafter	9
Total	\$ 38

UniSource Energy has guaranteed \$20 million of these natural gas transportation and supply payments.

OPERATING LEASES

UNS Gas has entered into operating leases, primarily for office facilities and office equipment, with varying terms, provisions, and expiration dates. UNS Gas' estimated future minimum payments under non-cancelable operating leases at December 31, 2003 follow:

UNS GAS, INC.
NOTES TO FINANCIAL STATEMENTS (CONTINUED)

Operating Leases	
-Thousands of Dollars-	
2004	\$ 524
2005	446
2006	459
2007	452
2008	419
Total 2004-2008	2,300
Thereafter	3,202
Total	\$ 5,502

UNS Gas' operating lease expense was \$0.2 million from April 14, 2003, the date of inception, to December 31, 2003.

UniSource Energy has guaranteed \$2 million in building lease payments for UNS Gas.

NOTE 7. ACCOUNTING FOR ASSET RETIREMENT OBLIGATIONS

In June 2001, the FASB issued Statement of Financial Accounting Standards No. 143, *Accounting for Asset Retirement Obligations* (FAS 143). It requires entities to record the fair value of a liability for a legal obligation to retire an asset in the period in which the liability is incurred. A legal obligation is a liability that a party is required to settle as a result of an existing or enacted law, statute, ordinance or contract. When the liability is initially recorded, the entity should capitalize a cost by increasing the carrying amount of the related long-lived asset. Over time, the liability is adjusted to its present value by recognizing accretion expense as an operating expense in the income statement each period, and the capitalized cost is depreciated over the useful life of the related asset. Upon settlement of the liability, an entity either settles the obligation for its recorded amount or incurs a gain or loss if the actual costs differ from the recorded amount.

UNS Gas has various transmission and distribution lines that operate under land leases and rights of way that contain end dates and restorative clauses. UNS Gas operates its transmission and distribution systems as if they will be operated in perpetuity and would continue to be used or sold without land remediation. As a result, UNS Gas is not recognizing the costs of final removal of the transmission and distribution lines in its financial statements. As of December 31, 2003, UNS Gas had accrued \$0.4 million for the net cost of removal for interim retirements from its transmission, distribution and general plant. These amounts have been recorded as a regulatory liability.

Amounts recorded under FAS 143 are subject to various assumptions and determinations, such as determining whether a legal obligation exists to remove assets, estimating the fair value of the costs of removal, estimating when final removal will occur, and the credit-adjusted risk-free interest rates to be used to discount future liabilities. Changes that may arise over time with regard to these assumptions and determinations will change amounts recorded in the future as expense for asset retirement obligations.

UNS GAS, INC.
NOTES TO FINANCIAL STATEMENTS (CONTINUED)

NOTE 8. INCOME TAXES

UniSource Energy includes UNS Gas' taxable income in its consolidated federal income tax return. Deferred tax assets (liabilities) as of December 31, 2003 consist of the following:

Deferred Tax Assets/(Liabilities)	
-Thousands of Dollars-	
Gross Deferred Income Tax Liabilities	
Plant	\$ (1,592)
Other	(19)
Gross Deferred Income Tax Liabilities	(1,611)
Gross Deferred Income Tax Assets	
Purchase Gas Adjustor (PGA)	167
Customer Advances	202
Contributions in Aid of Construction	166
Other	62
Gross Deferred Income Tax Assets	597
Net Deferred Income Tax Liability	\$ (1,014)

We record deferred tax liabilities for amounts that will increase income taxes on future tax returns. We record deferred tax assets for amounts that could be used to reduce income taxes on future tax returns. UNS Gas has determined that a valuation allowance on the deferred income tax assets at December 31, 2003, is not necessary. We reached this conclusion based on our interpretation of tax rules, tax planning strategies, scheduled reversals of temporary differences, and projected future taxable income.

Income tax expense (benefit) included in the income statement includes amounts both payable currently and deferred for payment in future periods as indicated below:

Income Tax Expense/(Benefit)	
-Thousands of Dollars-	
Current Tax Expense/(Benefit)	
Federal	\$ (236)
State	(51)
Deferred Tax Expense/(Benefit)	
Federal	832
State	182
Total Federal and State Income Tax Expense	\$ 727

The following reconciles the provision for income taxes at the federal statutory rate of 35% to the effective rate for the year ended December 31, 2003:

Income Tax Expense	
-Thousands of Dollars-	
Federal Income Tax Expense at Statutory Rate	\$ 632
State Income Tax Expense, Net of Federal Deduction	83
Other	12
Total Federal and State Income Tax Expense	\$ 727

UNS GAS, INC.
NOTES TO FINANCIAL STATEMENTS (CONTINUED)

NOTE 9. PENSION AND POSTRETIREMENT BENEFIT PLANS

UNS Gas does not maintain a separate pension plan or other postretirement benefit plan for its employees. All regular employees are eligible to participate in the pension plan maintained by the company's parent, UES. A small group of active employees are also eligible to participate in a postretirement medical benefit plan. UES allocates net periodic benefit cost based on service cost for participating employees.

PENSION PLAN

UES established a noncontributory, defined benefit pension plan for substantially all regular employees on August 11, 2003. Benefits are based on years of service and the employee's average compensation. UES has not yet funded the plan, but will contribute at least the minimum amount required under Internal Revenue Service regulations.

OTHER POSTRETIREMENT BENEFIT PLAN

UNS Gas assumed a \$0.8 million liability for postretirement medical benefits for current retirees and a small group of active employees at the acquisition of the Arizona gas system assets from Citizens. The select active employees participate in the TEP Postretirement Benefit Plan.

The ACC allows UNS Gas to recover postretirement costs through rates only as benefit payments are made to or on behalf of retirees. We fund postretirement benefits entirely on a pay-as-you-go basis. Under current accounting guidance, UES cannot record a regulatory asset for the excess of expense calculated per Statement of Financial Accounting Standards No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*, over actual benefit payments.

The actuarial present values of the pension benefit obligations and other postretirement benefit plans were measured at December 1. UES' benefit obligation, plan assets, and funded status for both UNS Gas and UNS Electric at December 31, 2003 follow:

	Pension Benefits	Other Postretirement Benefits
	-Thousands of Dollars-	
Benefit Obligation at End of Year	\$ 3,787	\$ 1,690
Fair Value of Plan Assets at End of Year	-	-
Funded Status	\$(3,787)	\$(1,690)

Amounts recognized in UNS Gas' Balance Sheet at December 31, 2003 include:

	Pension Benefits	Other Postretirement Benefits
	-Thousands of Dollars-	
Accrued Benefit Liability Included in Other Liabilities	\$ (526)	\$ (778)
Intangible Asset Included in Other Assets	309	-
Net Amount Recognized in the Balance Sheet	\$ (217)	\$ (778)

UNS Gas' net periodic benefit cost, employer contributions and benefits paid for the period August 11, 2003 to December 31, 2003 follow:

UNS GAS, INC.
NOTES TO FINANCIAL STATEMENTS (CONTINUED)

	Pension Benefits	Other Postretirement Benefits
-Thousands of Dollars-		
Net Periodic Benefit Cost	\$ 227	\$ 16
Employer Contribution	-	16
Benefits Paid	-	16

Weighted-Average Assumptions Used to Determine Benefit Obligations as of December 1,	Pension Benefits	Other Postretirement Benefits
Discount Rate	6.25%	5.50%
Rate of Compensation Increase	3.75%	-

Weighted-Average Assumptions Used to Determine Net Periodic Benefit Costs for the Period Ended December 31,	Pension Benefits	Other Postretirement Benefits
Discount Rate	6.50%	5.25%
Rate of Compensation Increase	4.00%	-

For measurement purposes, a 15 percent annual rate of increase in the per capita cost of covered health care benefits was assumed for 2004. The rate was assumed to decrease gradually to 5 percent for 2013 and remain at that level thereafter.

Contributions

UNS Gas expects to contribute \$0.7 million to the pension plan in 2004.

DEFINED CONTRIBUTION PLANS

UES sponsors a defined contribution savings plan that is offered to all eligible employees. The plan is a qualified 401(k) plan under the Internal Revenue Code. In a defined contribution plan, the benefits a participant receives result from regular contributions to a participant account. Participants direct the investment of contributions to certain funds in their account. UES makes matching contributions to participant accounts under this plan. Matching contributions to this plan for UNS Gas' participating employees were \$43,000 in 2003.

UNS GAS, INC.
NOTES TO FINANCIAL STATEMENTS (CONTINUED)

NOTE 11. SUPPLEMENTAL CASH FLOW INFORMATION

A reconciliation of net income to net cash flows from operating activities follows:

	Period April 14, 2003 (Date of Inception) to December 31, 2003
	-Thousands of Dollars-
Net Income	\$ 1,077
Adjustments to Reconcile Net Income to Net Cash Flows	
Depreciation and Amortization Expense	2,068
Amortization of Deferred Debt-Related Costs included in	
Interest Expense	27
Provision for Bad Debts	114
Deferred Income Taxes	727
Other	657
Changes in Assets and Liabilities which Provided (Used)	
Cash Exclusive of Changes Shown Separately	
Accounts Receivable	(13,974)
Materials and Supplies Inventory	80
Accounts Payable	3,350
Interest Accrued	2,452
Taxes Accrued	5,028
Other Current Assets	1,739
Other Current Liabilities	1,902
Net Cash Flows – Operating Activities	\$ 5,247

UES made non-cash equity contributions of \$1.4 million to UNS Gas that affected recognized assets and liabilities but did not result in cash receipts or payments.

On August 11, 2003, UniSource Energy acquired the Arizona gas and electric system assets from Citizens for \$223 million, comprised of the base purchase price plus other operating capital adjustments and transaction costs. In conjunction with the acquisition, liabilities were assumed as follows:

Purchase Price Allocation	
	- Thousands of Dollars -
Fair Value of Assets Acquired	\$ 152,698
Liabilities Assumed	13,983
Assets/Liabilities Purchased	\$ 138,715
Cash Paid for Citizens Assets	\$ 135,792
Transaction Costs	2,923
Total Purchase Price	\$ 138,715

UniSource Energy paid \$1.4 million of transaction costs included above that are not reported on UNS Gas' Statement of Cash Flows.

UNS GAS, INC.
NOTES TO FINANCIAL STATEMENTS (CONCLUDED)

NOTE 12. PROPOSED ACQUISITION OF UNISOURCE ENERGY

At a special meeting held on March 29, 2004, UniSource Energy's shareholders voted to approve an acquisition agreement UniSource Energy entered into on November 21, 2003 with Saguaro Acquisition Corp., a wholly-owned indirect subsidiary of Saguaro Utility Group L.P. (Saguaro Utility), providing for the acquisition of all of the common stock of UniSource Energy for \$25.25 per share. The acquisition agreement provides that Saguaro Acquisition Corp. will merge with and into UniSource Energy, with UniSource Energy surviving the merger as a wholly-owned indirect subsidiary of Saguaro Utility. UniSource Energy expects the acquisition, which is subject to several conditions, including certain regulatory approvals, to occur in the second half of 2004.

The acquisition agreement contains operating covenants with respect to the operations of UniSource Energy's business pending the consummation of the acquisition. Generally, unless UniSource Energy obtains Saguaro Acquisition Corp.'s prior written consent, UniSource Energy must conduct business in the ordinary course consistent with past practice and use all commercially reasonable efforts to preserve substantially intact the present business organization and present regulatory, business and employee relationships. In addition, the acquisition agreement restricts certain activities, subject to the receipt of Saguaro Acquisition Corp.'s prior written consent, including the issuance or repurchase of capital stock, the amendment of organizational documents, acquisitions and dispositions of assets, capital expenditures, incurrence of indebtedness, modification of employee compensation and benefits, changes in accounting methods, discharge of liabilities, and matters relating to UniSource Energy's investment in Millennium Energy Holdings, Inc.

Either UniSource Energy or Saguaro Acquisition Corp. may terminate the acquisition agreement in certain circumstances, including if the acquisition is not consummated by March 31, 2005 or certain regulatory approvals are not obtained. In certain circumstances, upon the termination of the acquisition agreement, UniSource Energy would be required to pay Saguaro Acquisition Corp.'s expenses and a termination fee in an aggregate amount of up to \$25 million.